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1		SECOND REHEARING DIRECT TESTIMONY
2		OF MARK RHODEN
3		ON BEHALF OF
4		THE SOUTH CAROLINA OFFICE OF REGULATORY STAFF
5		DOCKET NO. 2014-346-WS
6		IN RE: APPLICATION OF DAUFUSKIE ISLAND UTILITY COMPANY,
7		INCORPORATED FOR APPROVAL OF AN INCREASE FOR WATER AND
8		SEWER RATES, TERMS AND CONDITIONS
9		
10	Q.	PLEASE STATE YOUR NAME, BUSINESS ADDRESS AND OCCUPATION.
11	A.	My name is Mark Rhoden. My business address is 1401 Main Street, Suite 900,
12		Columbia, South Carolina 29201. I am employed by the State of South Carolina as the
13		Chief Financial Officer of the Office of Regulatory Staff ("ORS").
14	Q.	PLEASE STATE YOUR EDUCATIONAL BACKGROUND AND EXPERIENCE.
15	A.	I received my bachelor's degree in Financial Management from Clemson
16		University in May 1979. In the same month, I joined the audit staff of Ernst & Whinney
17		(currently Ernst & Young, "EY") auditing both privately owned and publicly traded
18		companies for five years. I earned my Certified Public Accountant ("CPA") designation
19		in March of 1982. In 1984, I joined Colonial Life & Accident Insurance Company as
20		Director of Audit; I served as Audit Director for six years and then rotated into other
21		functions such as Sales, Operations, Investments Accounting, and Financial and Statutory
22		reporting. I was with Colonial Life for sixteen years. In 2000, I joined a niche Executive

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1		Recruiting Firm, MBI Financial Staffing, Inc., as Executive Recruiter and served nine
2		years. In 2009, I joined United Sporting Companies (Ellett Brothers) as VP of Financial
3		Planning and Analysis responsible for planning, budgeting, financial and operational
4		analysis for nine years. In August of 2019 I joined ORS as Chief Financial Officer
5		responsible for the Audit and Administrative Departments.
6	Q.	HAVE YOU TESTIFIED PREVIOUSLY BEFORE THE PUBLIC SERVICE
7		COMMISSION OF SOUTH CAROLINA ("COMMISSION")?
8	A.	No. This is my first-time providing testimony before the Commission.
9	Q.	WHAT IS THE MISSION OF THE OFFICE OF REGULATORY STAFF?
10	Α.	ORS represents the public interest as defined by the South Carolina General
11		Assembly as follows:
12 13 14 15		[T]he concerns of the using and consuming public with respect to public utility services, regardless of the class of customer, and preservation of continued investment in and maintenance of utility facilities so as to provide reliable and high-quality utility services.
16	Q.	WHAT IS THE PURPOSE OF YOUR DIRECT TESTIMONY IN THIS SECOND
17		REHEARING PROCEEDING?
18	A.	The purpose of my direct testimony is to present my findings from an internal and
19		objective review of ORS's audit practices as it relates to this proceeding in which I sought
20		to determine if:
21		ORS performed its review in a manner consistent with proper audit standards.
22		ORS's recommendation to allow recovery of \$211,600 in rate case expenses is the
23		total allowed recovery of \$272,382 less \$60,782 allowed for bond expenses.

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1 Q. DESCRIBE YOUR AUDIT EXPERIENCE IN PUBLIC ACCOUNTING WITH 2 ERNST & WHINNEY.

While at EY, I participated in the planning and execution of audits following Generally Accepted Auditing Standards ("GAAS") as required by the American Institute of Certified Public Accountants. EY is one of the largest international CPA firms whose role is critical to ensuring the public trust is maintained in the US financial markets, therefore, EY's practices for designing and conducting audit tests are based on GAAS. One of the key standards of field work is the auditor must obtain sufficient understanding of the entity, its environment, including its internal controls, to assess the risk of material misstatement of the financial statements whether due to error or fraud, and to design the nature, timing, and extent of further audit procedures. Furthermore, audit standards provide guidance on determining the quantity and quality of audit evidence needed in audit testing to assist the examination team in the formation of conclusions.

14 Q. DESCRIBE YOUR EXPERIENCE AT COLONIAL LIFE IN CONDUCTING 15 INTERNAL AUDITS.

As Director of Audit at Colonial Life, I was responsible for leading the audit team in planning and executing internal audits over both financial reporting and operational functions to ensure management properly discharged their responsibilities. Similar audit principals are applied to internal audits as used for external audits. However, financial audits by CPA firms primarily focus on testing the fairness of financial statements, whereas operational audits cover the many functions within an organization needed to accomplish

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1		organizational goals. In order to effectively audit the operations within an entity, a
2		fundamental understanding of the organization is needed.
3	Q.	DID YOU REVIEW ORS'S RECOMMENDATION RELATED TO THE RATE
4		CASE EXPENSES REQUESTED BY DIUC?
5	A.	Yes. ORS recommended DIUC be allowed to recover \$211,600 of the total
6		\$794,210 requested. A group of expenses that were not allowed in the amount of \$542,978
7		from Guastella Associates, LLC ("GA") make up the majority of the difference. Generally
8		Accepted Auditing Standards require the auditor to obtain sufficient appropriate audit
9		evidence to afford a reasonable basis for an opinion regarding financial statements under
10		audit. This principal, of sufficient appropriate evidence, is applied to all audits and within
11		it is implied both quantity and quality of the evidence. ORS witness Hipp's Revised
12		Hearing Testimony listed the following criteria to ensure DIUC invoices and supporting
13		documentation included for ratemaking meet "known and measurable" standards.
14		1. The invoice is mathematically correct;
15		2. The invoice is for a valid business purpose;
16		3. The expense was incurred during the period under review;
17		4. The invoice was properly recorded on the books and records of the Company; and
18		5. The invoice was paid by Company.
19		ORS witness Hipp's testimony also described the quality of evidence needed by
20		ORS to evaluate the valid business purpose of this \$542,978 as follows: "describe work

performed, the specific dates and hours of work, employee name, and business purpose"

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Ĺ	The invoices provided by DIUC do not provide that level of information. Upon my review
2	I concluded that the ORS evaluation was appropriate.

Q: DO THE DIUC RATE CASE INVOICES PROVIDE A QUALITY LEVEL OF INFORMATION THAT CAN BE VERIFIED BY AN AUDIT?

No. In the examination of an invoice, invoices that are received from parties independent of management and the entity under audit, and invoices that include information that explains in detail, the activity, timing and nature of the work or product are considered quality information when applying auditing principles Additionally, an invoice that has not been paid is of lower quality evidence as compared to an invoice that has been paid. Payment of an invoice is not sufficient evidence, in and of itself, but the actual payment along with sufficient business purpose together represent a quality level of evidence to assist the auditor in forming a conclusion. ORS witness Hipp's testimony stated the invoices "[d]o not appear to be paid by DIUC." In ORS witness Hipp's Rehearing Surrebuttal Testimony dated December 5, 2017, witness Hipp contrasted the above GA invoices with an invoice provided by Pratt-Thomas-Walker. The Pratt-Thomas Walker invoice provided quality evidence and was allowed by ORS. In regard to making a determination whether to allow this \$542,978 in rate case expenses, DIUC did not provide ORS quality audit information to support allowance. ORS followed objective auditing standards in its evaluation of the rate case expense.

Q. IS THE LACK OF AN ARMS-LENGTH TRANSACTION BETWEEN THE VENDOR GUASTELLA ASSOCIATES, LLC AND DIUC A FACTOR IN AN AUDIT OF EXPENSES FOR THIS UTILITY?

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Yes. ORS witness Hipp made the point that GA rate case invoices "requires a careful review by ORS" because of the "apparent lack of arms-length transaction." This is a result of GA having total control over DIUC accounting and operations and at the same time has the ability to invoice the same company it controls, record the expense on DIUC books, and generate a DIUC payable to GA. The management agreement provisions indicate GA exercises full day-to-day control over the utility both financially and operationally. This lack of separation of duties, at the highest level in the utility, represents one of the most significant weaknesses in internal accounting control recognized by any auditor and by the audit profession. Additionally, ORS witness Hipp made the following statements, "parent company and individual stockholders appear to exercise limited decision-making authority, there is little to protect the rate payer from unfair dealings by DIUC's management company, GA." This point is emphasized in the management agreement itself: "[o]nly the president has the authority on behalf of the Company to direct GA and GA shall have the right to rely upon direction from the president as having full authority to act on behalf of the Company without the need to confirm such authority with the Company's board of directors, the Stockholders, the Parent or any other third parties." (See REHEARING EXHIBIT DMH-4, ARTICLE II. SCOPE OF SERVICES page 3 of 9) Witness Hipp also stated, "DIUC's contract with GA for management fees and lack of contract with GA for work performed related to general rate increase proceedings has resulted in DIUC delegating all management, executive and policy functions to its vendor. GA. As such, the risks associated with those decisions have been passed to the ratepayer."

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- 1 (REHEARING SURREBUTTAL TESTIMONYAND EXHIBITS OF DAWN M. HIPP,
- 2 lines 3-6, page 13 of 13)

3 Q: HOW DO AUDITORS REVIEW TRANSACTIONS WHERE THE APPROVER OF

THE INVOICE ALSO CREATED THE INVOICE?

Auditors are regularly faced with the fact that segregation of duties within small organizations is not always practicable to mitigate risk. This may be a fair characterization of DIUC. However, in these situations, a public utility is obligated to its shareholders and its ratepayers to ensure other compensating controls are in place to mitigate this significant control risk. I can find no reference to compensating controls, and DIUC failed to address how they mitigate this risk in its rebuttal. There is no discussion demonstrating compensating controls are in place. DIUC must provide a higher quality of support for these invoices. Whether the Commission's review of the invoices is the only compensating control DIUC has with regard to rate case expense is a question I cannot answer. As well, the Company offers no information as to whether any independent audit has been performed of DIUC financials. In this case, where there is lack of both segregation of duties and compensating controls, audit standards demanded increased testing. ORS reviewed 100% of GA invoices and required more specific explanations from the Company. ORS appropriately followed audit standards and ORS performed "a careful" review of the invoices.

Q. WILL YOU UPDATE YOUR DIRECT TESTIMONY BASED ON INFORMATION

21 THAT BECOMES AVAILABLE?

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- Yes. ORS reserves the right to provide supplemental testimony should new information not previously provided by the Company, or other sources become available.
- 3 Q. DOES THIS CONCLUDE YOUR DIRECT TESTIMONY?
- 4 A. Yes, it does.